

Expropriation Claims for Increased Development Costs and Loss of Profit

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abstract

Claims for loss of developer's profit and for increased development costs have been inappropriately advanced as an enhancement of market value in a number of Canadian expropriation cases. Provision for developer's profit or development costs, while made explicit in the subdivision development method, is implied in the sales comparison approach. Market value is an "as is" premise, and only when the sales comparison approach is applied is it evident that unearned developer's profit or unexpended development costs cannot serve to increase an estimate of market value.

Claims for increased development costs¹ and for loss of profit have been advanced in a number of Canadian expropriation cases involving land with subdivision potential. Both types of claims are part of the same equation, as increased development costs reduce profit, which in an economic sense is treated as a residual. Profit from subdivision activity is dependent on lot revenues and development costs, and is fully realized only upon completion and successful disposition of finished lots. However, unearned profit cannot be added to the market value of expropriated land to enhance the amount of compensation to which a property owner is entitled.² Market value remains the measure for land taken.

Profit and Risk

Profit is the motivation and expectation behind every economic venture, but the realization of profit depends on the outcome of the venture. Profit from subdivision is realized only if the venture generates enough revenue from consummated lot sales to exceed the cost of all of the agents of production (land, labor, capital, and entrepreneurial coordination), taking into account the time value of money.

The subdivision process has many stages, each with varying degrees of anticipated and unanticipated risk, and the realization of profit ultimately depends on successfully overcoming all of the risks. Broadly speaking, the subdivision development process carries with it the following categories of risk:

- Permitting risk, which includes risks related to failure to obtain subdivision approval (i.e., executed subdivision or development agreement) and the re-

1. Anticipated increased development costs are distinguished from "costs thrown away" as a direct consequence of the expropriation and not captured in the market value estimate.

2. In *Ridgeport Developments v. Metropolitan Toronto Region Conservation Authority* [1976], 11 L.C.R. 143, 156, the board rejected "the proposition that a land developer, who is compensated for the market value of land expropriated from him, should be entitled to additional compensation for the loss of profit that might have been realized from a development which, but for the expropriation, might have taken place."

quired letter of credit guaranteeing completion of infrastructure improvements (i.e., performance bond), or to overcome any private impediments off the land (i.e., required easements and landowners' cost share agreements).

- Development risk, which includes risks related to potential development barriers (i.e., environmental constraints), delays (i.e., strikes and inclement weather), infrastructure cost overruns, and unexpected expenditures.
- Marketing risk, which includes risks related to failure to sell finished lots in a timely and profitable manner. The marketing risk is greater in the early phases of a subdivision and less after a successful development has a proven sales record. A large subdivision carries more marketing risk than a small one, as it will take longer to absorb all of the finished lots. Marketing risk results from too many finished lots (i.e., oversupply/inadequate demand); noncompetitive finished lot pricing; wrong size and/or type of finished lots (i.e., changing consumer housing preferences); economic conditions (i.e., mortgage rate increases, housing affordability, recession, plant closings); and unexpected competition from other subdividers/developers (i.e., inventory not anticipated in the initial market study).

Risk levels can be significantly impacted by the expected number and timing of periodic lot dispositions, including the corresponding revenue stream, within the anticipated absorption period due to the time value of money and unanticipated changes in market conditions over time.

Overcoming the marketing risk is the key to profitable subdivision development. A prudent developer will not execute a subdivision agreement or construction contract unless builder presales of permit-ready lots for all or an acceptable number of lots in the proposed subdivision have been negotiated. Applying a coordinated approach to subdivision devel-

opment reduces project risk, and, as construction costs and anticipated revenues from lot sales are more predictable, the developer is able to measure potential profitability more accurately. Nonetheless, conditional builder lot presales may not close for a host of reasons, causing the developer to hold and incur the carrying costs of unsold lot inventory, reducing or possibly eliminating any expected profit.

Lovell and Martin describe developer's profit (entrepreneurial profit) as a continuum in a viable market,³ and address the possibility of no profit in the subdivision process as follows:

The developer begins to earn this profit at project inception. The returns grow as the land is bought, plans are drawn up, [planning] approvals are received [and permits obtained], financing is secured, construction bids are let, construction is begun and ultimately completed, and the lots are sold [absorbed]. It is difficult to quantify exactly how much is earned at each step of the project. It is even conceivable that the project will fail in its later stages of development, resulting in the loss of most or all of the implied profit earned up to that time.⁴

Market Value Premise

Market value is founded on an "as is" basis, not on an "as if" or assumptive premise; the distinction between the two premises is shown in their definitions. *Value as is* is defined as follows:

The value of specific ownership rights to an identified parcel of real estate as of the effective date of the appraisal; relates to what physically exists and is legally permissible and excludes all assumptions concerning hypothetical market conditions or possible rezoning.⁵

An "as if" or assumptive premise implies a contingent and prospective value;⁶ this is described in the following definition of *prospective value opinion*:

A forecast of the value expected at a specified future date. A prospective value opinion is most frequently sought in connection with real estate projects that are proposed, under construction, or under conversion to a new use, or those that have not achieved sellout or a stabilized level of long-term occupancy at the time the appraisal report is written.⁷

3. Douglas D. Lovell and Robert S. Martin, *Subdivision Analysis* (Chicago: Appraisal Institute, 1993), 16–19.

4. *Ibid.*, 94.

5. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: Appraisal Institute, 2002), 306.

6. An "as if" or assumptive value estimate bypasses the cost associated with the time, carrying charges, and financial outlays required to achieve the value estimate, and makes no provision for risk and entrepreneurial profit associated with achieving the assumptive premise, as future events, occurrences, decisions, approvals, or rulings vital to the value estimate are treated as if they had already taken place.

7. *The Dictionary of Real Estate Appraisal*, 224. According to the *Canadian Uniform Standards of Professional Appraisal Practice*, "land use controls must be identified and their effect on use and value analyzed, together with any reasonably probable modifications of such regulations in light of economic demand, the physical adaptability of the real estate, and market area trends" and "the use of the real estate existing as of the effective date of the appraisal must be included to distinguish the use from the highest and best use." Appraisal Institute of Canada, *Canadian Uniform Standards of Professional Appraisal Practice* (Ottawa, ON: Appraisal Institute of Canada, 2005), Lines 1551–1554 and Lines 1560–1562. Lennhoff and Parli contend that in the definition of *highest and best use* there is an ambiguity in the statement "reasonably probable and legal use," as the conjunction "and" suggests that only currently legal uses that are reasonably probable be considered. David C. Lennhoff and Richard L. Parli, "A Higher and Better Definition," *The Appraisal Journal* (Winter 2004): 45–49.

The courts have looked at the basis of market value claims in developable land expropriation cases, and they have limited market value to the value of the land in its “as is” condition.

In *Jabbour v. Bassatne*,⁸ a dispute arose as to meaning of market value⁹ in the valuation of raw land. There, the appeals court ruled that

A reasonable person would assume land to be equivalent to specified cash only in its current [“as is”] condition on the competitive market, not after costly alterations as yet unmade had turned it from raw land into a “developable” condition...[and as the trial court observed,] “the prudent, well informed buyer would know the current condition of the land and pay a reasonable price for the land, not a price that assumed the land to be in a ‘different’ or ‘more developed’ condition.”

In *Wammco, Inc. v. Commonwealth Transp. Comm’r*,¹⁰ the Supreme Court of Virginia rejected evidence of a claim for adjustment costs (increased development costs) in connection with a partial taking and affirmed that market value on an “as is” basis serves as the measure of severance damages. The *Wammco* court offered the following guidelines in determining damages:

- The test of damage to the land remaining after a taking is the difference in the residue’s value immediately before and immediately after the taking, and in determining such damages consideration may be given to every circumstance, present, or future that affects the residue’s value at the time of the take, but remote or speculative advantages and disadvantages are not to be considered.
- Adjustment costs, sometimes referred to as increased development costs, are relevant to determining any diminution in the market value of the residue. However, such costs are not the measure of damages and cannot be recovered specifically. Evidence of the cost of necessary improvements is admissible, but is not a measure of damages.

- The measure of damages to the residue remains the difference in value before and immediately after the taking, less any enhancement resulting from the take.
- Like any other evidence of damage to the residue, evidence of adjustment costs is inadmissible if it is based on remote or speculative factors.
- It is the present actual value of the land with all its adaptations to general and special uses, and not its prospective, or speculative, or possible value based upon future expenditures and improvements that is to be considered.

Evidence ought to be considered regarding the anticipated increased costs of developing a remainder parcel¹¹ if those costs are not speculative or remote and have an influence on market value; however, those costs are not determinative of market value. Separate assessments of the elements comprising damages can function only to assist in determining the market value of a remainder, and not to incrementally enhance a damage claim for injurious affection (severance damages) as a double form of compensation.¹²

In Canada, the seminal case of *Pastoral Finance Association v. The Minister*,¹³ established that the special suitability of land for an owner’s business and the additional profits that the owner might expect to derive from it, are proper elements of assessing compensation only to the extent that they impact market value. The owner, however, is not entitled to have the value of those potential savings and profits added to the market value of the land. The Privy Council explained the principle in the following manner:

...[The landowners are] entitled to that which a prudent man in their position would have been willing to give for the land sooner than fail to obtain it... [N]o man would pay for land in addition to its market value

8. *Jabbour v. Bassatne*, 673 A.2d 201 (D.C. App. 1996).

9. The court in *Jabbour* referred to the definition of *market value* contained in the *Uniform Standards of Professional Appraisal Practice* at that time, which was relied upon by the appraisers representing the parties in the case: “The most reasonable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale with the buyer and seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus.” Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice* (Washington, DC: The Appraisal Foundation, 1996).

10. *Wammco, Inc. v. Commonwealth Transp. Comm’r*, 251 Va. 132, 465 S.E.2d 584 (1996), 1996 Va. LEXIS 18.

11. *Remainder* is defined in eminent domain condemnation (expropriation) as “that portion of a larger parcel remaining in the ownership of the property owner after a partial taking.” *The Dictionary of Real Estate Appraisal*, 242; see also the definition of *larger parcel*, *ibid.*, 160.

12. Under Ontario’s *Expropriation Act*, the term *injurious affection* is defined as “(a) where a statutory authority acquires part of the land of an owner (i) the reduction in market value thereby caused to the remaining land of the owner by the acquisition or by the construction of the works thereon or by the use of the works thereon or any combination of them, and (ii) such personal and business damages, resulting from the construction or use, or both, of the works as the statutory authority would be liable for if the construction or use were not under the authority of a statute, or (b) where the statutory authority does not acquire part of the land of an owner, (i) such reduction in the market value of the land of the owner, and (ii) such personal and business damages, resulting from the construction and not the use of the works by the statutory authority, as the statutory authority would be liable for if the construction were not under the authority of a statute...” *Expropriation Act*, RSO 1990, c. E.26, s. 1(1).

13. *Pastoral Finance Association v. The Minister* [1914] A.C. 1083.

the capitalized value of the savings and additional profits which he would hope to make by the use of it. He would, no doubt, reckon out those savings and additional profits as indicating the elements of value of the land to him, and they would guide him in arriving at the price which he would be willing to pay for the land, but certainly if he were a business man that price would not be calculated by adding the capitalized savings and additional profits to the market value.

Conceptual Plans of Subdivision

Claims for increased development costs that have not been expended have dubious merit as injurious affection claims (severance damages) when applied to conceptual plans showing “paper lots” (before and after the taking). Paper lots cannot be individually conveyed or encumbered, and, as such, have no market value. As to claims for loss of profits attributed to paper lots, there can be no entitlement to profit that has yet to be earned; since no lots physically exist, none are legally available for disposition. Conceptual plans of paper lots prepared in anticipation of expropriation should be viewed with skepticism as a means of establishing injurious affection (severance damages) or as justification for use of the subdivision development method.

In *Sutherland v. Township of Langley*, the hearing board examined conceptual plans and rejected the subdivision development method as inappropriate and speculative. The board noted that “it is appropriate to use [that] method where there is a paucity of comparable sales” and that in this case there was not a paucity of comparable sales.¹⁴ The board in rejecting the subdivision development valuation also pointed to the speculative nature of valuation of conceptual plans.

There are also indications that the [subdivision] Development Approach would be unreliable or weak in its application to this case. At the time of the acquisition, the [claimants] had made no move to subdivide their land; therefore it was necessary for [the appraiser] to hypothesize the most likely scheme. ...First, it appears that [the appraiser] was particularly optimistic in all his assumptions, indicating the upper end of value by this method. Second, the plans provided were in preliminary format, not engineered, and not fully dimensioned. They were developed for the purpose of advancing the claimant's case rather than as a subdivision for Preliminary Layout Approval... [T]here was some question as to whether they would actually have been approvable. Third, a large number of assumptions had to be made and a change to any one of

these would result in a different value conclusion. ...In the circumstances of this case, this approach was not reliable since development had not been commenced, the site layout was not close to approval, and lot price and costs had not been established.¹⁵

Highest and Best Use

In the expropriation of land, claims for increased development costs and loss of profit are typically advanced through the use of the subdivision development method applying discounted cash flow (DCF) analysis, often on the unsupported premise that subdivision is the highest and best use and development is imminent.

Approaches to Value

The subdivision development method and the sales comparison approach¹⁶ are the primary approaches applied in the valuation of land with subdivision potential. While each approach is directed at estimating market value, the treatment of development costs and developer's profit is distinct in each approach.

In the subdivision development method, anticipated development costs are stated and the provision for profit is made explicit, either as a separate line item or indirectly explicit as part of the discount rate in a DCF model.

In the sales comparison approach, anticipated development costs and potential profit are implied rather than addressed separately as individual components of the value estimate.

The commingling of the two distinct valuation approaches with respect to the provision for profit can cause confusion, as shown in the expropriation case of *Torvalley Development Ltd. v. Metropolitan Toronto Region Conservation Authority*.¹⁷ In *Torvalley Development*, the claimants offered evidence of two appraisers' opinions of the market value of the property. The valuation opinion of one appraiser was \$26.5 million, based on the subdivision development method, and included an allowance of 15% for profit. The other valuation opinion was \$19 million based on the sales comparison approach.

The Ontario Municipal Board preferred the more conservative value estimate of \$19 million indicated by the sales comparison approach, but pointed out

14. *Sutherland v. Township of Langley*, 68 L.C.R. 49, 58.E. (September 23, 1999), board quoting E.C.E. Todd, *The Law of Expropriation and Compensation in Canada*, 2nd ed. (Toronto: Carswell, 1992), 220.

15. *Ibid.*

16. The sales comparison approach is a set of procedures in which a value indication is derived by comparing the property being appraised to similar properties that have been sold recently, applying appropriate units of comparison, and making adjustments to the sale prices of the comparables based on the elements of comparison. *The Dictionary of Real Estate Appraisal*, 255. The term *comparative analysis* is generally used to identify the process by which quantitative and/or qualitative techniques are applied to derive a value indication in the sales comparison approach. *Ibid.*, 55.

17. *Torvalley Development Ltd. v. Metropolitan Toronto Region Conservation Authority* (69 O.R. 92d), 508 [1989].

that the appraiser developing that opinion had not allowed for a reasonable profit factor in his valuation, and suggested that he had overlooked it. The board took the valuation of \$19 million, but then deducted from it a factor of 15% for profit—as had been imputed by the other appraiser in his subdivision development approach—and awarded \$16.15 million.

On appeal, the court found that the board's deduction of 15% for profit from the estimate of market value based on the sales comparison approach was inappropriate. The court increased the award to \$19 million, with the trial judge commenting as follows:

...[The appraiser] explained in his evidence that the price paid in each of his comparable sales had built into it the assessment for risk and profit which the developer making the purchase regarded as necessary.... The result was that the price indicated for the subject property by each comparable sale would include an allowance for [anticipated] profit.

Subdivision Development Method

Claims for increased development costs are typically confined to partial takings, unless presented as a claim for loss of profits. Claims for loss of profits have been advanced in both partial and whole takings. Use of the subdivision development method provides fertile ground for advancing these claims.

The Appraisal of Real Estate lists the following analytical steps that are required in the execution of the subdivision development method:¹⁸

- Accurately determine the highest and best use of the land
- Create or affirm a supportable subdivision development plan
- Determine the timing and cost for approval and development (including mitigation needs and costs of obtaining development entitlements)
- Forecast a realistic pricing schedule over time¹⁹
- Forecast accurately the lot absorption rate and price mix (including properly supported projections of community or market growth over the absorption period)
- Estimate accurately the staging or phasing of land development and related expenses

- Forecast marketing and related holding expenses over the absorption period
- Estimate the annual real estate taxes
- Include overhead and an entrepreneurial [developer's] profit allowance in the discount rate and/or line item allocation for entrepreneurial [developer's] profit
- Estimate the appropriate discount rate consistent with the selection of the line item allocation for entrepreneurial [developer's] profit²⁰

When no actual subdivision exists legally or physically, use of the subdivision development method superimposes nonexistent lots on the land, and derives a contingent value predicated on explicit and implied assumptions.

In addition to being very complex, time-consuming, and costly to prepare, when misapplied or used on its own without an abundance of reliable market data, the subdivision development method can be the least accurate raw land valuation technique.²¹ An indication of value based solely on the subdivision development method is not amenable to verification as a measure of market value.

Sales Comparison Approach

The sales comparison approach, with its reliance on bona fide sales data, provides a better indication of value than a subdivision development prospectus.²² A truly comparable sale would be similar in size, and possess similar development potential in timing of development and utility, and appeal to the same category of prospective purchaser (i.e., a developer). Accordingly, all expected infrastructure (development) costs, direct and indirect, and anticipated profit from development and ultimate sale (absorption) of finished lots/blocks, would be reflected in the sale price of the comparable raw land sale in its "as is" condition.

In *Ridgeway Associates, Inc. v. State*,²³ the court recognized that a comparable's price includes development costs, stating as follows:

The comparable sales relied upon...in valuing the subject property involved properties purchased by developers for development purposes and accordingly were sales

18. Appraisal Institute, *The Appraisal of Real Estate*, 12th ed. (Chicago: Appraisal Institute, 2001), 343.

19. The projected pricing schedule must be based on comparable lot sales. Comparable lot sale prices that have been affected by atypical financing should be converted to a cash-equivalent price.

20. The discount rate must be sufficient to account for the time value of money, the opportunity for financial loss (risk) and for an outcome that is not certain (uncertainty), and developer's profit (entrepreneurial incentive) if not included as a separate line item in the pro forma.

21. *The Appraisal of Real Estate*, 12th ed., 342. See also *Sutherland v. Township of Langley*.

22. Appraisal Institute, *The Appraisal of Real Estate*, Canadian Edition (Chicago: Appraisal Institute, 1992), 297.

23. *Ridgeway Associates, Inc. v. State*, 300 N.Y.S.2d 944, 947 (N.Y. 1969).

in which development costs have been considered and were reflected in the sale price. To add an increment to the value established based on these sales is to inflate and distort the market value of the subject property.

Similarly, in *United Artists Theatre Circuit, Inc., et al., v. State*,²⁴ it was pointed out that

[t]he court actually valued the property as having a residential development potential by relying upon the State's comparable sales.... [T]here was no need for a separate increment value to be found by the appraisers or the court because the market data inherently included that value in raw acreage sales.

Appraisal Practices Standards

It is inappropriate to advance appraisal theories and methodologies in support of claims for increased development costs and loss of profit without a proper legal foundation. Acceptance of the subdivision development method by the courts typically requires a showing that the sales comparison approach is not suitable as a means of estimating land value; the highest and best use of the land is a subdivision; and the foundational requirements of the subdivision development method have been met.

In addition, the appraisal theories or methodologies used must be consistent with the professional practice standards of the Appraisal Institute of Canada's (AIC) *Canadian Uniform Standards of Professional Appraisal Practice* and the practices in the field.²⁵ Valuing raw land without any planning and subdivision approvals as if it were an actual subdivision and applying the subdivision development method is not a practice endorsed by the AIC.²⁶ Raw land should, whenever practical, be valued by way of the sales comparison approach.

Furthermore, to maintain credibility as an expert witness in litigation and quasi-judicial proceedings, an appraiser must act independently of legal counsel or client influence. It remains the appraiser's professional responsibility and duty to

- analyze and determine highest and best use;
- select recognized and appropriate valuation approaches;²⁷
- apply the valuation approaches properly; and
- develop unbiased opinions of value.

Appraisers sometimes rely on the Jurisdictional Exception of the AIC Standards,²⁸ an assignment condition that voids the force of a part or parts of the Standards, when preparing reports in contemplation of litigation or quasi-judicial proceedings. Failure to disclose in the report the part or parts of the Standards that have been disregarded, and the legal authority justifying this action, can be misleading and unethical. The Jurisdictional Exception provides that

In every case, it is ultimately the responsibility of the appraiser under the "Reasonable Appraiser" test, and not the client or other intended users, to determine whether the use of the Jurisdictional Exception is appropriate.²⁹

An appraiser qualified by a court or administrative board to give testimony as an expert witness is afforded significant latitude in submitting opinion evidence. Qualifying as an expert witness does not, however, entitle an appraiser to promote appraisal theories and methodologies that deviate from recognized concepts of market value, and that fail to comport with applicable professional practices outside the courtroom.

Conclusion

When developing an opinion of market value for expropriation, an appraiser should employ those methods and practices applied in the real world, as recognized and endorsed by the appraisal profession. The inappropriate focus on development costs and profit as separate components of value is misleading and distracts from the primary objective—which is to estimate market value—and has the potential of providing compensation twice.³⁰

24. *United Artists Theatre Circuit, Inc., et al., v. State*, 384 N.Y.S.2d 543, 544 (N.Y. 1976).

25. The AIC Standards may differ from those applicable in the United States, and standards and practices in eminent domain differ from state to state within the United States.

26. AIC Claim Prevention Bulletin CP-7, Revised Oct. 1994, 3, states "...[T]he Residual Approach should only be used when development of the site is not too distant, there is obvious demand for the resultant product, and there is at least some documentary evidence that such a development will be approved. Ideally, the development or subdivision plans should be available, all municipal consents obtained, and necessary services available. It is certainly not desirable to take a piece of raw land, assume a potential development, and proceed to the Residual Approach. In addition, the Residual Approach should never be used without the Sales Comparison Approach in at least a 'back-up' role." Also see Bulletin CP-7, August 1993, "Application of the Residual Approach to Value."

27. AIC Claim Prevention Bulletin CP-6, Revised Oct. 1995, 4, cautions that "unless the appraiser can justify the use of the method of appraisal to the Courts, the Professional Liability Insurance Program, and perhaps the Complaint Investigation Committee [of the AIC], **DO NOT USE IT**. It is no excuse that the client requested it. The client does not dictate to the appraiser the content of **ANY** appraisal report. If this causes a problem with the client, then the appraiser is duty bound to decline the assignment. To do otherwise is a contravention of our professional standards."

28. *Canadian Uniform Standards of Professional Appraisal Practice*, Lines 80–90.

29. *Ibid.*, Lines 87–90.

30. In *British Columbia Hydro and Power Authority v. Bossio Motors Ltd.* [1983] B.C.J. No. 104, in denying Bossio's claim for "loss of profits," the appeals court stated that "...there is no merit in this claim for profit. His profit, if any, is in the value of the land in the right of way. If he were to recover for loss of profits too, he would receive double compensation."

Neither unexpended development costs nor unearned developer's profit can be added as an enhancement to the market value of undeveloped land. When sold at market value, land with subdivision potential reflects an "as is" price that ensures sufficient financial incentive for a prospective developer-purchaser to make the necessary capital expenditures and undertake the steps to bring about successful subdivision, including disposition of serviced lots. The provision for development costs (and lot revenues) and profit is either implied, as in the sales comparison approach, or made explicit, as in the subdivision development method through DCF analysis.

Only in the application of the sales comparison approach is it evident that claims for increased development costs and loss of profit are without merit, and have no impact on the market value of land in its "as is" condition, whether the valuation is of a partial or whole taking. In a partial taking from land with subdivision potential, both the before and after valuation scenarios are independent exercises, and each estimate of market value must stand alone.

Advancing claims at the behest of legal counsel without a proper legal foundation for increased development costs that have not yet been expended (or that a prospective purchaser does not anticipate expending in the near future following acquisition) and loss of profits that have yet to be earned is inappropriate and inconsistent with the concept of market value, which is an "as is" premise.

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